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Where's the Value in This Pricey Market?

Fund pro Mike O'Higgins likes "Dogs of the World" stocks, platinum, and even Treasury bonds.

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Being a 43-year veteran of the investment wars, I have experienced more than a few business and market cycles. During that time, I have been surprised at how many average investors and so-called investment experts fail to understand some of the most basic long term investment truths and allow short term conditions to affect their long term plans. The result is that most investors fail, by wide margins, to even come close to the long term returns of the average mutual fund, or even the market averages.

The latest evidence of this phenomenon came last year from a study by Morningstar which found that investors underperformed the average mutual fund by 2.5 percentage points annually during the previous 10 years. Studies by Dalbar have produced similar results.

One of the most basic investment truths is that investing in value stocks has resulted in much higher compounded annual returns than buying and holding growth stocks over the long term. Growth stocks are sexier, but boring value stocks pay better over time. In spite of this fact, investors today are pulling money out of some of the best value-oriented mutual funds, such as Third Avenue Value, Wintergreen and Tweedy Browne Value, and switching into zippier growth funds because of their relative outperformance since the Crash of 2008.

Growth stock investing involves the purchase of shares in companies that are currently experiencing high rates of revenue and, hopefully, earnings growth, and are projected to continue growing at a rapid rate in the foreseeable future.

Generally, these stocks have had very strong relative price performance compared to stocks, in general, and trade at relatively high prices as measured by conventional metrics such as price to earnings (P/E), price to sales (P/S) and price to book (P/B). Normally, they also pay little or nothing in the way of dividends.

Value investors, on the other hand, seek to invest in companies whose shares trade for less than what they believe is their "intrinsic value." As a rule, value stocks are depressed in price for any number of reasons, be they poor conditions currently prevailing in their industries, or management errors that have caused their sales and earnings to decline. The result is that value stocks normally sell at relatively low P/E, P/B and P/S ratios and have high dividend yields.

Going back to the beginning of 1928, according to Ibbotson Associates, large cap value stocks have beaten large cap growth stocks in 57 of the last 87 years, compounding at a rate of 11.27% per year versus 9.14% per year for their "growthier" competitors. While this 2.13 percentage point advantage may seem small, over time the difference is substantial. A dollar invested in value stocks at the beginning of 1928 would have grown to $11,298 through May of this year, or almost 5 1/2 times the $2,090 that would have resulted had that same dollar been invested in a growth stock portfolio over the same period.

In spite of the huge cumulative difference in favor of value stocks over the above-mentioned almost nine decades, recent history has shown two extended periods in which growth stocks have significantly beaten value stocks: 1993 through 1999 when growth stocks returned 298.1% versus 168.8% for Value, and 2007 through May 2015 when growth stocks had a cumulative return of 108.2%, almost double value stocks' 56.6% total return. During the intervening period, the post internet bubble years of 2000 through 2006, value stocks trounced growth stocks by returning 69.4% while a portfolio of growth stocks lost 29.5%. But that is ancient history to investors who seem intent on repeating the mistakes revealed in the long term studies mentioned in the first paragraph of this article.

So, you might ask, besides investing in a typical value stock fund, where might an investor find value today? At O'Higgins Asset Management, we have our money deployed in what we consider to be some of the best relative value options available in the four broad sectors to which we limit ourselves: what we call our "Dogs of the World" (40%), long term U.S. Treasury bonds (20%), intermediate term U.S. Treasury notes (20%) and physical platinum (20%). In the following paragraphs, we will explain why.

The Dogs of the World (DOTW) are what we consider the five cheapest investable equity markets in the world. Going back to the beginning of 1996, they have compounded at 14.56% annually during a period when the S&P 500 returned roughly half of that and the Morgan Stanley World Index did less than 1/3 as well. This year's DOTW are Brazil, Hong Kong, Poland, Russia and Singapore. Through the end of May, they are +6.4%, on average, not including their substantial dividends, compared to the S&P's +3.2%.

Long term U.S. Treasury bonds would not appear on many investment observers' lists of undervalued assets but consider the following.

According to Sydney Homer, the author of *The History of Interest Rates*, since Babylonian times high quality long term debt has paid two percentage points over the long term rate of inflation. Ibbotson Associates tells us that, in the postwar period since 1945, long term U.S Treasuries have yielded 5.9% annually while inflation, as measured by the Consumer Price Index (CPI), averaged 3.8%. For the past 12 months, CPI is -0.58%, according to the most recent report. So, if inflation is negative, what's wrong with 3.1% on 30 year T-Bonds?

Intermediate Treasury notes at 2.4% are, likewise, throwing off a better than 2% "real" yield but have another relative comparative advantage when compared to yields available on other high quality sovereign debt. Maybe the Swiss deserve to sell 10 year debt at 0.12% (it was negative a few weeks ago) and the Germans and Dutch at 1.06% and 0.86%, respectively. But how about Spain at 2.15% or Italy at 2.16%? Does anyone really think that they are more likely to make their interest and principle payments than we are? And let's not even consider that most of them are denominated in a depreciating currency versus the U.S. dollar.

Our last undervalued investment is one that you won't find on very many Wall Street recommended lists, either: physical platinum. While we normally invest 25% of our money in either gold or platinum, right now we have 20% in platinum for two reasons. One, after our DOTW have one of their infrequent losing years, we take 5% points from each of our other three sectors and boost our equity percentage up to 40%, leaving the remaining 60% to be divided equally among the other sectors. Second, because platinum, which due to its relative rarity versus gold normally trades 25% higher in price than gold, is currently almost 7% below gold. As far as gold's relative undervaluation, its price has historically averaged 1/10 the price of the Dow Jones Industrial Average and, as I write, it is only 1/15th ($1,181/18,039) the price of the Dow. Therefore, in our view, fair value for platinum right now would be $2,255/oz or 105% above its current price of $1,100/oz if historical relationships were to return.

For the first five months of 2015, our median portfolio using the above-mentioned allocation is +0.94%, net of fees, while the S&P 500 and DJIA are +3.1% and +2.1%, respectively. Since 1972, our Michael O'Higgins Absolute Return (MOAR) Strategy, which is the basis for that allocation, has averaged a 12.42% compounded total return, with only four losing years, compared to the S&P's 10.33% and nine negative years. That's why we call it "MOAR Return with Less Risk."

O'Higgins is president and chief investment officer of O'Higgins Asset Management. He is the author of the best-selling investment classic Beating the Dow (HarperCollins, 1991), which popularized the "Dogs of the Dow" strategy.

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